1 December 2017

ASIC Enforcement Review
Financial System Division
The Treasury
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## ASIC's Directions Powers

The Australian Financial Markets Association (AFMA) is commenting on the Consultation and Position Paper 8 ASIC's Directions Powers (Paper).

AFMA is a member-driven and policy-focused industry body that represents participants in Australia's financial markets and providers of wholesale banking services. AFMA's membership reflects the spectrum of industry participants including banks, stockbrokers, dealers, market makers, market infrastructure providers and treasury corporations.

In summary, AFMA considers that the Paper presents insufficient analysis independent of ASIC views to make out the policy case for the proposed directions powers. Significantly more policy development work is needed before positions in the Paper could be considered ready to be moved forward.

### 1. General observations on Paper and Review

#### *1.1. Inconsistency with current regulatory framework*

AFMA is concerned about the lack of an analytical policy framework for the ASIC Enforcement Review in general. The starting point for our analysis is to look to the most recent review of the financial regulation through the Financial System Inquiry (FSI). It is important to recall the general policy guidance that should prevail in review work:

> *The Inquiry's approach to policy intervention is guided by the public interest. Given the inevitable trade-offs involved, deciding how and when policy makers should intervene in the financial system requires considerable judgement. Intervention should seek to balance efficiency, resilience and fairness in a way that builds participants' confidence and trust. Intervention should only occur where its*

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*benefits to the economy as a whole outweigh its costs, and should always seek to be proportionate and cost sensitive.*

The FSI Report did recommend a product intervention power which is being implemented. It did not, however, find justification for a directions power in relation to AFSLs. Financial services licensing was developed in the context of conduct regulation which was fundamentally distinguished from prudential regulation under the framework bequeathed to us by the 1997 Report on the Australian Financial System (Wallis Inquiry). Under this framework regulation constitutes an interference with the natural forces of the market. Thus, regulatory intervention must be justified on the grounds of market failure. Financial markets fail for four main reasons:

- anti-competitive behaviour;
- market misconduct;
- information asymmetry; and
- systemic instability.

What is interesting about these four sources of market failure is that, by and large, they require different regulatory tools to counteract the market failure. The Wallis inquiry concluded that there was a strong case to create one regulator to deal with each of the four sources of market failure. As has been demonstrated in other jurisdictions there is fundamental clash of cultures from putting two regulatory functions under the same roof. The Wallis Inquiry concluded that market-conduct regulation and prudential regulation were so different in their methodologies and scope that bringing them together under the one roof would inevitably lead to tensions between cultures, resource allocation and regulatory focus. Conduct regulation seeks to ensure that market participants behave within ethical and statutory parameters that do not harm the market. In contrast to prudential regulation it does not involve direct intervention in the commercial decision making of a financial services businesses. The law set outs the parameters within which financial services licensees must operate and the obligations they owe to investors. Financial service licensees must configure and conduct their businesses in conformance with the law or suffer the consequences for transgressions. However, within those parameters licensees are free to make their own business judgments. This contrasts to prudential regulation where prudentially regulated entities must accept the possibility of being directed in their business decision making to maintain the sustainability and strength of the financial institution.

The Paper does not make out a case for changing the underlying approach to and character of conduct regulation. There is argument by analogy in the Paper with financial market infrastructure regulation in relation to market licensees. This is done for the purpose of market integrity not conduct regulation. As is the case with prudentially regulated entities, the sustainability of financial market infrastructure is of high importance to market integrity and provides the policy justification for directions powers.

### *1.2. Consultation prior to finalising recommendations of Review*

We note that the Review by the taskforce has been wide ranging and that its positions have been presented through eight position papers, which have been consulted on separately, and at different times. While we appreciate that due to complexity of the issues under review, perhaps necessitating this siloed consultation approach, providing feedback on each position paper's proposals has been challenging given they each form

part of a wider package of reforms to ASIC's enforcement regime coming out of the Review.

We strongly encourage the taskforce to publish for relatively short consultation with industry a draft package of recommended reforms resulting from its Review – this would include its recommendations from each of the eight position papers positioned in the context of one another. This should always be the approach when there is a "package" of related regulatory changes that affect the whole of the financial services industry.

This will be vital to enable industry to consider the package as a whole and thereby give more meaningful feedback. This would be entirely consistent with the phased approach to consultation adopted during the Financial System Inquiry.

### *1.3. Review needs first to address effective use of existing ASIC power*

There is insufficient analysis in the paper on how the outcomes identified by ASIC may be (or are unable to be) achieved using the existing powers. The Government has over the last twenty years constantly expanded ASIC's regulatory tool-kit and enforcement powers which are already broad and sophisticated. The starting point for the Review needs to be on ASIC's use of its current tool-kit.

The ASIC Capability Review Panel in 2015 considered ASIC's enforcement approach in some depth and determined that:

> *ASIC's articulation of its role, especially by the leadership, shows too heavy an emphasis on enforcement, which is often a reactive tool. This is also reflected in ASIC's resource allocation to the enforcement function far exceeding that of peer regulators. This enforcement emphasis in communications and resourcing risks prioritising strategic focus and staff orientation too much towards this single aspect of the regulatory toolkit. While enforcement is a critical element of ASIC's toolkit, especially in terms of its deterrence impact and overall credibility of the regulator, in the Panel's view, a better balanced approach emphasising the full scope and use of ASIC's regulatory toolkit would be more appropriate for a modern and dynamic conduct regulator.*[1]

The views of the ASIC Capability Review should be a starting point for the ASIC Enforcement Review so as to analyse ASIC's management of deterrence and enforcement before jumping to the conclusion that additional powers are required. The arguments put forward in the Paper for the need for the directions power are not firmly founded on intrinsic failing of the current deterrence and enforcement powers provided to ASIC. This can be illustrated by examining justifications for change made in the Paper.

First, the Paper argues that "*the resources and procedural requirements necessary to impose additional conditions, or to suspend or cancel a license can result in delay between concerns arising and ASIC achieving a protective outcome*"[2]. It is important to note the potential cause of this delay is the requirement to afford procedural fairness or natural

[1] Capability Review of the Australian Securities and Investments Commission (ASIC) Panel, Fit for the future, A capability review of the Australian Securities and Investments Commission, A Report to Government December 2015. Page 11

[2] As exampled by paragraph 4 of the Executive Summary of the Paper

justice to license holders. The requirements of procedural fairness are acknowledged in the paper[3]. These are the requirements to give a licensee notice of a proposed direction, give notice of the reasons for making the proposed direction, and give the licensee a reasonable opportunity to respond before the direction is made. These are valuable safeguards that protect the legitimate business interests of licensees. But they are not inflexible.

Secondly, the Paper raises the concern that "applying to a court for an injunction involves significant time, resources and costs in investigating and preparing a case to the required standard to commence court proceedings"[4]. If the intention here is to assert that the judicial process is too slow and burdensome, this a proposition that AFMA does not accept as a valid criticism. It is commonplace for private litigants to obtain injunctive relief very quickly. Some orders, such as Mareva injunctions and Anton Piller orders, must, of their nature, be sought very quickly. And, unlike ASIC, private litigants must prepare such cases without the benefit of compulsory information gathering powers. In any event, to the extent that the requirement to gather evidence is a cause of delay, it is a justifiable cause. Given the significance of the impact that license changes and injunctive orders can have on a business, it is quite appropriate that the regulator have a rational and demonstrable basis for making them that justifies action to the independent judgment of the court.

Thirdly, the Paper comments that enforceable undertakings are effective only as an alternative to the exercise of other powers[5]. AFMA does not agree with proposition. It is only in relation to criminal sanctions that an enforceable undertaking is not available as an alternative. According to ASIC's own Regulatory Guide 100, ASIC may accept an enforceable undertaking instead of seeking a civil order from a court, taking administrative action, or referring the matter to another administrative body. ASIC can also accept an enforceable undertaking when such an undertaking may change the compliance culture of an organisation. To achieve this, the promisor usually promises to stop the alleged contravention, implement a compliance program to prevent the future occurrence of similar breaches, and/or rectify any negative impact the conduct may have had on the general public. Accordingly, an enforceable undertaking aims to:

- protect the public;
- prevent similar future breaches from occurring;
- change the compliance culture of an organisation; and
- correct the effect of the contravention.

The fact that enforceable undertakings operate as alternatives to compulsory outcomes has no bearing on what the range of those outcomes should be.

### *1.4. Characterisation of directions powers*

AFMA also discerns an underlying assumption of the Paper is that there are things that licensees should be required to do that are not set out in any of the comprehensive legislation that applies to the provision of financial services and credit activity. The Paper is in effect putting forward positions to give ASIC the power to fill these supposed gaps. Such a power is in its true nature either:

[3] See paragraph 8, section 3.1 of the Paper
[4] See, eg, paragraph 5 of the Executive Summary of the Paper
[5] See, eg, paragraph 6 of the Executive Summary of the Paper

- a legislative or rule-making power, in which case it should be exercised by Parliament; or
- a judicial power, in which case it should be exercised by a Chapter III court.

Our understanding leads us to believe that the Review may be contemplating something in between these alternatives, perhaps a regime comparable to the powers exercisable by the Takeovers Panel, held to be valid by the High Court in *Attorney-General (Cth) v Alinta Ltd [2008] HCA*. AFMA wishes to be clear that we do not agree with such thinking. Firstly, such thinking is inconsistent with the practical justifications given by the Paper for the new powers. Although Takeover Panel proceedings are quick, experience has shown that they are not necessarily any quicker than administrative action or judicial intervention. More importantly, an important aspect of the reasoning in the Alinta case was that the Panel comprised subject matter specialists making decisions based on considerations and interests that are not apt for judicial decision-making. That cannot be said of the issues in question here. How licensees should conduct their businesses and treat their customers are already the subject of extensive legislation and judicial consideration.

## 2. Questions on Positions

### *2.1. Position 1 - ASIC should have the power to direct financial services or credit licensees in the conduct of their business where necessary to address or prevent compliance failures*

#### *2.1.1. Position 1 Q 1*

*Should ASIC be able to give a direction to a financial services or credit licensee requiring them to take or refrain from taking specified action in the conduct of their business where necessary to address or prevent compliance failures?*

As noted in AFMA's submission on the Reviews' Position Paper 7 on Strengthening Penalties, given the most serious implications of these positions for individuals, corporations, and the business environment, a failure to show that changes are justified as a matter of good policy process means they should not proceed further without more thinking on how the financial services laws operate in a proportionate and rational manner.

In AFMA's view, the Position Paper has not provided convincing justification for the proposed ASIC directions powers. The powers proposed are not necessary as ASIC can achieve the same outcomes using its current suite of enforcement tools.

In particular, if the matter is urgent and consumers need to be protected, it is open to ASIC to seek an interim injunction under section 1324 of the *Corporations Act*. ASIC is able to seek an urgent injunction and be put to proof before the court of an arguable case and that the balance of convenience justifies the making of such orders. The current approach appropriately safeguards the rights of persons from unhindered administrative action by making the regulator accountable to

an independent arbitrator in the form of the court. Matters of such significance should be reserved to the court.

The fact that ASIC must gather evidence to support its concerns before a court is a necessary restraint on the exercise of administrative power. It is appropriate that a regulator have sufficient evidence to be satisfied that a breach has occurred or will occur before it exercises such significant powers.

Seeking and interim injunction does not necessarily require significant resources and costs. An interim injunction should be able to be sought in a matter of days (or hours), if there are real concerns about significant consumer detriment. Other regulators, which have less wide ranging powers, e.g. ACCC, are very experienced in seeking interim injunctions to prevent consumer detriment occurring in the short term.

There is a risk that if a direction power were conferred on ASIC and that power were to be would be used with insufficient caution and due diligence because it provides a temptingly easy route to action without the necessary accountability mechanisms in place that apply to other form of action. Significant damage could be done to financial services providers for no other reason than it may be difficult for ASIC to prove its case.

The rest of the questions presuppose agreement with the need for a directions powers. As indicated AFMA does not agree that the policy case has been made out and our following responses to questions on the design of directions powers should not be taken as supporting such powers.

If the direction power were created, it would at a minimum need the following safeguards which are additional to those canvassed in the Position Paper.

- A direction should only apply for a limited timeframe of 21 days (which would align with the markets infrastructure directions power).
- Use of the direction power should be a last resort, when use of ASICs other powers would be ineffective in the circumstances. ASIC should be required to have clear reasons why this is the case.

AFMA also notes that there is no consideration of statutory protection for licensees that act in accordance with an ASIC direction for claims from consumers or third parties. We encourage the Review taskforce to consider legislating for this protection.

### *2.1.2. Position 1 Q2*

*Should the directions ASIC can make be prescribed in the legislation (with an ability to extend the list by regulation)? If so, is the above list appropriate?*

From our preceding comments it can be seen that the application of directions powers to financial services licensees would be seen by AFMA as a highly significant development. The list of directions that ASIC can make should be set out in the Corporations Act and not be extendible by regulation. Even more crucial there should be no contemplation of delegation of rule-making to ASIC in this area. It is the role of the political process (such as a combination of the executive and legislature) to set out the framework of regulation and the parameters within which it should operate.

### *2.1.3. Position 1 Q3*

*Alternatively, should a directions power be drafted broadly to allow for a wider variety of directions?*

AFMA does not support wide drafting. It is the role of the political process (such as a combination of the executive and legislature) to set out clearly defined laws and the parameters within which the regulator should operate.

It is commonly argued, when laws are being created, that regulators should be allowed the flexibility needed to adjust to inevitably changing circumstances. Markets and circumstances evolve with time and it is prudent to enable regulators to make appropriate incremental changes. It is also argued that policy-makers are not prescient. It is not possible for them to anticipate all issues that require policy-making to resolve. Rather than attempting to manage all technical details, delegation of authority to regulators to fill in policy details is deemed to be a pragmatic way to deal with complex issues.

The difficulty this situation poses is that regulators can suffer from a tendency to 'mission creep', relying on their delegated discretions to extend the law beyond the intentions of political policy-makers. Where financial markets are concerned such rule-making can result in substantive interventions in the way markets operate without a conscious public debate occurring through a moderated political process to determine whether the right policies are being adopted. Accordingly, great care needs to be taken in the delegation of discretions to regulators.

### *2.2. Position 2 - The directions power should be triggered where ASIC has "reason to believe" that a licensee has, is or will contravene financial services or credit licensing requirements (including relevant laws)*

#### *2.2.1. Position 2 Q4*

*Should the directions power be triggered if ASIC has reason to believe that a licensee:*

*a. has engaged, is engaging or is proposing to engage in conduct that constituted, constitutes, or would constitute a contravention of a law relevant to the provision of services by the licensee?*

*b. has refused or failed, is or is proposing to refuse or fail to do an act or thing that the legislation requires a financial services or credit licensee to do?*

The trigger for action set at ASIC having a 'reason to believe' is too low a threshold. It is disproportionate for a regulator to have power to make directions that can significantly impact the ability of a licensee to continue carrying on its business on the basis of ASIC only having a 'reason to believe.'

It is useful to note in this regard that direction powers of regulators in other jurisdictions which may be exercised without a public hearing, for example in New Zealand and UK, are generally only invoked if the regulator is **satisfied** that a breach has or is likely to occur.

The test in Regulatory Guide 98 that ASIC has 'reason to believe' is set for future likely breaches, not for past activity. AFMA considers the test should be amended to a standard of ASIC having a 'reasonable basis to satisfy itself' (or at a minimum a 'reasonable basis to believe') that the conduct / failure to act has occurred this a clearer objective test.

#### *2.2.2. Position 2 Q5*

*Alternatively, should broad public interest considerations or objectives provide the basis for ASIC making a direction? If so, are the objectives outlined above appropriate?*

Yes.

ASIC's objectives under the ASIC Act should be a further requirement for the exercise of the directions power to ensure that there is broader benefit to the use of the power and as a further limitation on unbounded use of an administrative power (i.e. on top of the objective 'reasonable basis' test above). ASIC has a clearly defined mandate, so any actions they take should be restricted to their objectives.

Public interest needs to be balanced with the potential damage done to the holder of a financial services license if ASIC's decision is poorly made. Requiring ASIC to justify its position before enforcing such directions is a better outcome form both a public interest and regulatory policy perspective.

### *2.3. Position 3 - ASIC should be able to apply to a court to enforce the direction and take administrative action if an AFS or credit licensee does not comply with a direction*

#### *2.3.1. Position 3 Q6*

*Should ASIC be able to apply to a court to seek an order requiring a licensee to comply with the direction?*

Qualified yes.

Such an application by ASIC should subject to the licensee's being entitled to challenge the validity of the direction via response to written notice or in hearings. We make further comment below on these safeguards.

#### *2.3.2. Position 3 Q7*

*If so, should there be sanctions, in addition to those relating to contempt, for a licensee and/or its directors if the licensee breaches the court order?*

No

The doctrine of contempt was developed to allow courts to punish those who interfered with the administration of justice and encompasses failing to comply with a court order or an undertaking given to a court. This is a matter for court administration not additional law in the Corporations Act.

#### *2.3.3. Position 3 Q8*

*Should failure to comply with an ASIC direction be a:*

a. *criminal offence?*
b. *civil penalty provision?*
c. *breach of a financial services law or credit legislation and therefore a basis for administrative action?*

It should not be a criminal offence. Compliance should be based on a breach of a financial services law or credit legislation and therefore a basis for administrative action.

These are orders that relate to licensee's obligations and therefore any breach of these are subject to administrative or civil penalty action. The penalty for failing to comply with the direction should not exceed the remedies for the primary breach available under the Corporations/Credit Act.

#### *2.3.4. Position 3 Q9*

*Should ASIC be required to give written notice to a licensee before making a direction setting out: its intention to make a direction, reasons and a period of time for the licensee to respond that is reasonable in the circumstances?*

Yes

ASIC should be required to provide a statement to the licensee at least 5 business days in advance of giving a direction. This statement should set out ASIC's intention to make a direction, ASIC's reasons for giving the direction. The licensee should have at least 5 business days to respond to the statement before ASIC issues the direction.

This would enable the financial services provider the opportunity to address the concerns with ASIC or seek its own injunction on the basis of ASIC's having failed to provide a proper foundation for its "reason to believe" (or an alternative higher threshold as recommended above).

#### *2.3.5. Position 3 Q10*

*Alternatively, should ASIC be required to offer the affected licensee an opportunity to appear, or be represented at a hearing and to make submissions on the matter before making a direction? If so, should ASIC also be able to make an interim direction without providing a hearing and be required to provide a hearing within a certain time frame?*

Yes

ASIC should be required to offer the affected licensee an opportunity to appear, make submissions, and be represented at a hearing.

ASIC should be required to provide a hearing before making an interim direction without. If the matter requires an urgent response to prevent consumer detriment, ASIC can seek an interim injunction which will leave the 'balance of convenience' consideration to the court.

While the following is expressed as an alternative, it is the view of AFMA that ASIC should be required to provide both written notice and to the opportunity for the licensee to appear at a hearing. If ASIC is given the power to make an interim direction without providing a hearing, safeguards for the licensee should be put in place. For example, ASIC should not be able to make an interim direction without a hearing if the direction is likely to have a significant impact on the licensee's ability to carry on its business.

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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